

Audit's MARKET ANALYSIS OF SECURITIES OF REITS AND REAL ESTATE COMPANIES Realty Stock Review

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MARKET STRATEGY: 'IS THE WORST YET TO COME?' ASKS FORBES. 'NO,' WE THINK

Forbes Magazine has just discovered the difference between economic occupancy and physical occupancy*, in its latest look at real estate markets. The article, complete with photo of an empty Houston office tower, hints of even darker things ahead for builders and lenders in the troubled oil patch.

There's no doubt that things are tough in the oil patch, and so far the stock market has been willing to believe the worst about companies located there:

--Lomas & Nettleton Financial of Dallas, nation's largest mortgage banker, dropped over 9 points (or 20%) on news it added \$3.5 mil. to its loss reserve; Dow-Jones helped the slide by conveniently forgetting the decimal in reporting a \$35 million provision.

--L&N Housing, participating mortgage trust managed by LNF, also dropped like a stone one day, touching 17 before recovering to about 23. The reason: an analyst for a major brokerage discovered what we reported to you last April 11 and cut his earnings estimate to \$2.40/sh. from an unrealistic \$3.

* Difference between vacated tenants still paying rent and those in physical occupancy in their premises.

These instances show the "sell first, ask questions later" syndrome that currently spooks the market for realty stocks, especially oil patch realty stocks. The other fear is that interest rates will rise, which sparked last week's 86 point nosedive by the Dow-Jones Industrials. As to real estate markets, we've spent much time in the oil patch over this summer and find (a) real estate is really tough and (b) most pessimism seems overdone.

In the stock market, we haven't seen such a spread between stock prices (or yields) for years, almost solely based on geographic location of properties. REITs operating shopping centers in the strong Northeast have super-low yields (e.g., 5.2% for Federal Realty and 5.7% for New Plan Realty, v. 6.7% for Weingarten Realty, a Houston based shopping center operator, and 11.4% for Property Trust of America, El Paso based REIT about 50% in shopping centers.

All the moaning misses what looks like the biggest news of all for real estate investors: **The cost of money has fallen far faster than effective rents in many projects, so that developers can make more on their net cash investment, and that more has a higher value because it's capitalized at lower rates.** We review several companies which appear to benefit from this trend.

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RANKING REVIEWS: BAY FINANCIAL, AMREP HOLD RANKS DESPITE OIL PATCH; CENTEX UP

Bay Financial Corp. (\$27.25--NYSE) holds B Rank in our annual review. Once a REIT, BAY is becoming a national investment builder by selling surplus properties to generate cash flow to fund its national building program. BAY has now slowed new construction to stress leasing and expects ongoing operations to be cash flow positive in 1-2 years.

EPS/Dividends - B: BAY earned 58¢ in its May 1986 fiscal year, up 222%. But BAY has been in such an aggressive construction/portfolio reshuffling mode the past two years that the numbers don't really tell the story. BAY's asset sales for 1986 netted \$3.86/sh., up 128%, with most volume coming from sale of coop units at Plymouth Towers in Manhattan. Most remaining units will close in the Aug. qtr. to net about \$1.85/sh. After that very few asset sales are expected in FY 1987, and operating losses probably will produce losses or breakeven in other quarters.

BAY must eat start-up losses during lease-up periods for new buildings coming on stream beginning either when a tenant takes occupancy or one year from completion. Operating cash flow was 46¢ in the red in 1986, vs. 5¢ positive in 1985 with a much smaller portfolio. This puts a premium on leasing: BAY leased 521,000 sq. ft. in 1986, up 40%, and ended the year with 953,500 SF available in buildings completed or under construction. With only one new building under construction, BAY has less than a two-year supply at current leasing pace.

Assets and Operations: BAY's \$273.2 mil. assets are 55% completed properties; 25% land; 9% joint ventures and construction in progress; and 11% mortgages. Completed properties of \$152 mil. are 27% cash flow positive; 57% not flowing positive; and 12% condos and housing held for sale. Like every other building owner, BAY is finding effective rents are slipping from pro forma rent schedules but that slippage is being more than offset by lower mortgage financing.

Example: BAY began building 275,000 SF Corporate Center in the Boston suburb

of Waltham two years ago and invested \$28.5 mil. Space is now 80% committed, including lease to a national company relocating its headquarters from downtown Boston, at effective rents that exceed initial projections even after concessions and tenant improvements. (BAY says it could cut rents \$5/SF or about 20% and still meet original profit projections.) The building was projected to earn BAY 15% on net cash at a 12% mortgage rate. Now BAY finds it can refinance at about 9%, and a \$46.7 mil. mortgage is scheduled to close later this month. BAY has only \$28.5 mil. invested, so it will pick up about \$18 mil. free cash after holdbacks, and enjoy infinite return on its negative investment. It's so happy that it will begin a second 280,000 companion building this year.

Not everything in BAY's expanding holdings is a home run but overall BAY is doing very well. A rundown by cities:

--Jacksonville: A 120,000 SF office completed in 1986 is 15% leased and renting slowly.

--Atlanta: BAY owns four industrial buildings in booming Norcross and the fourth (131,000 SF) is renting well and BAY is expanding.

--Phoenix (Chandler): a 90,000 SF building is about 20% leased and slow. A 55,000 SF Scottsdale office fell to 62% when a tenant defaulted. A 41,500 SF office near Arizona Biltmore is 88% leased and BAY is adding 11,000 SF.

--Tucson: A 40,000 building has rented slowly although a major tenant may take most space; the first building in this park is 100% leased.

--Dallas (Las Colinas in Irving): BAY is finishing ("The last crane in Las Colinas") the 196,000 SF Texas American Bank Plaza in this major high-rise office development; leasing is slow but a major company may take most space. An older 81,000 SF building is 91% leased. (See also Southland Corp., p. 4).

--Orlando: Near Major Center, a 105,000 SF research/development building is nearly 50% leased.

--King of Prussia, Pa.: BAY bought two buildings with 141,000 SF as part of an exchange involving Plymouth Towers; they are 83% leased. A nearby motel, acquired for future building, earns 32%.

--Newport Beach, Cal.: BAY's 350-room Sheraton Newport has been clobbered by impact of 3,000 new area rooms and lost money at a 61% occupancy; losses are expected in 1987. BAY sold the underlying land in 1983 and leased it back, reporting \$12 mil. gain.

Financial Measures - B: Total debt of \$215.3 mil. is 3.5 times \$62.2 mil. shareholders' equity at cost (equal to \$18.46/sh.). The debt mix is shifting as BAY added \$55 mil. secured debt on properties to total \$171 mil. at year-end. The Waltham mortgage will increase this further in 1987 and is similar to a corporate financing. Floating-rate bank debt is down to \$24 mil. now.

Current value: BAY reports current value rose 10.2% in 1986 to \$45.20/sh., or \$151.5 mil. The current value reflects lower capitalization rates for completed properties partly offset by haircuts on the Sheraton Newport, some land inventory, and some slow buildings.

Exposure - B: Boston-based BAY has shown ability to attract major national tenants to its properties, which has aided leasing. This ameliorates the leasing risk in many overbuilt markets. BAY is near but hasn't yet achieved positive operating cash flow.

Centex Corp. (\$36.63--NYSE) rises to A Rank due to increasing financial muscle and earnings consistency. The stock of this diversified homebuilding and construction giant has risen sharply in recent weeks and we hear the reasons are continued stock buybacks and a new board member who has often preceded investor David Murdock's interest.

EPS/Dividends - A: CTX earned \$2.62 sh. in its March 1986 year, up 30.4%. June qtr. EPS of 76¢ were ahead by 10%. CTX operating earnings have risen at 28% annual rate the past five years. Dividends held at 25¢ annual rate.

Assets and Operations: CTX operates three major business lines: homebuilding, with 42% of \$1.4 bil. revenues and 63% of after-tax income but before corporate overhead; general contracting, 47% of revenues but only 7% of income; and construction products, mainly cement, 11% of revenues and 30% of income.

Homebuilding, carried out by Fox & Jacobs in Texas and Centex Homes else-

where, is aiming at becoming a full-service company that builds homes, finances them via a mortgage subsidiary, and may resell them thru a residential brokerage unit. CTX delivered 6,095 homes in 1986, up 1.6%, with 49% in Texas and the southwest, the rest in 11 metropolitan markets (e.g., Chicago, Minneapolis, Northern Calif., Fla., Washington, Atlanta). June qtr. deliveries of 1,518 units rose 7% and backlog rose 15% to 2,649 units. Fox & Jacobs has stressed first-time buyers but now is entering the move-up market as well. CTX pulled out of oil-impacted markets in Tulsa, Oklahoma City and Little Rock in 1986 but remains active in Dallas/Fort Worth, Austin and Houston. CTX entered Jacksonville in the June qtr. by buying ARMS Corp., largest homebuilder there with about 500 DU annual volume; ARMS includes mortgage and title units. CTX Mortgage Co., unconsolidated mortgage banker, contributed \$3.9 mil. net income (21¢) and sold \$571 mil. of collateralized mortgage obligations.

Construction product sales rose 12% and income rose slightly. Imported cement continued to shave margins on cement, the fall balanced by profits from a new gypsum wallboard line added in 1986. In June CTX finalized a joint venture with Lehigh Portland Cement which will both produce and import Mexican cement for the Corpus Christi, San Antonio and lower Rio Grande Valley markets. CTX owns four cement plants, near Austin, Tex. (being contributed to the joint venture); Reno, Nev.; LaSalle, Ill.; and Laramie, Wyo., acquired in 1986 and being renovated.

General contracting revenues rose 30% in 1986 but margins continued under competitive pressure. Backlog at June 30 of \$522 mil. was off 16%.

Financial - A: Debt of \$96 mil. at June 30 is 0.28 times \$340 mil. shareholders equity, or \$19.03/sh. The leverage ratio has fallen for six straight years since debt/equity ratio peaked at 2.6:1 in 1980. CTX has done this while buying back stock fairly consistently over the past three years, buying 792,000 shs. at \$23.16 avg. last year.

Exposure - : CTX manages volatile business to produce fairly consistent EPS, and finances are very strong.

Amrep Corp. (\$22.13--NYSE) retains C Rank. A major land developer in New Mexico, AXR also builds in Denver and Orlando. EPS/Dividends - C: AXR earned \$2.15/sh. in its April 1986 year, up 40%. AXR earned 60¢ in the July qtr., up 5%. The big boost to EPS was \$13.9 mil. in bulk sales of low-priced land at its Rio Rancho Estates near Albuquerque, for industrial and residential use; gross margin contribution wasn't disclosed but we estimate these sales generated the bulk of \$15.6 mil. operating realty profit. AXR pays no dividends.

Assets and Operations: AXR began as an installment land seller at 91,000 acre Rio Rancho outside Albuquerque but hasn't sold undeveloped lots since 1977. Albuquerque's growth has brought the two communities closer, aided by construction of a new bridge over the Rio Grande River. About 30,000 of 103,000 platted lots remain unsold, and AXR retains ownership of 26,000 acres, of which 6,000 are in contiguous blocks suitable for development. Population now is about 25,000 and AXR is the dominant homebuilder, delivering 877 homes at an average \$53,940 in 1986. A 140 acre Technology Center has attracted an Intel Corp. plant, J.C. Penney distribution facility, and postal mail handling facility. Intel exercised an option in the July qtr. to buy 80 acres for \$3.3 mil. (\$41,250/ac.) to double plant space to 450,000 SF. AXR also agreed to sell 450 acres over several years to the Boyle Development Co. to build a \$300 mil. resort community with 4,000 homes and townhouses plus amenities.

AXR also delivered 49 units at condo projects in Aurora, Col., near Denver, and in Orlando.

The Kable News Co. subsidiary is a major magazine and book distributor and generated \$1.6 mil. operating profit.

Financial Measures - B: Debt of \$43 mil. is 0.8 times \$54.3 mil. equity or \$12.36/sh. About \$17.8 mil. (41%) of debt is variable rate of bank credit line debt; the rest is mortgages or other fixed rate. AXR also has \$30.6 mil. deferred tax liabilities (\$6.96/sh.) and some portion may drop to equity under the proposed lower tax rates. In Feb. 1986 AXR lost a U.S. Supreme Court appeal of an FTC ruling that AXR used deceptive practices to sell lots before 1976. The FTC may seek redress for consumers, but has not decided to do so.

Exposure - C: While AXR has substantial unrealized value in its Rio Rancho holdings, realizing these values will take time. Ventures into traditional homebuilding in Denver and Orlando have encountered soft markets.

NEWS BRIEF: SOUTHLAND FINANCIAL REBOUNDS FROM LOWS AS LEASING PACE HOLDS UP

Southland Financial Corp. (\$18--OTC) has recovered after dipping briefly below 15. As developer of the prime Las Colinas tract outside Dallas (RSR, June 13), SFIN shares are often a barometer of market sentiment on prime Sunbelt offices. SFIN's June quarterly reports leasing 905,650 SF in the first half of 1986, down 15.8% and 15.6% from the pace in the second and first halves of 1985 respectively. It reported an 80.2% occupancy in the 18.96 mil. SF completed commercial space in Las Colinas. The 2.29 mil. SF under construction are 64.4% preleased. See Bay Fincl., p. 2.

COMPARATIVE REALTY STOCK GROUP AVERAGE 09/10/86

GROUP NUMBER & NAME	DIV	NON-DIV	TOTAL	SHARE (000)	BOOK VALUE	ANNUAL DIV	EARN ANN	LAST PRICE	-% CHANGE AUG 20	FROM JAN 1	P/E RATIO	ANNUAL YIELD	% PR TO BK	RETURN ON BK	MARKET VAL(000)
1 PROPERTY REITS	40	6	46	5984	11.03	1.19	1.10	15.93	1.5	11.6	14.5	7.4	44.4	10.0	4667.5
2 PROP & MTG COMB REITS	19	2	21	5237	12.37	1.34	1.30	15.42	2.3	4.0	11.9	8.7	24.6	10.5	1850.4
3 MORTGAGE REITS	17	2	19	5839	15.45	1.76	2.39	16.02	0.3	9.7	6.7	11.0	3.7	15.5	1862.7
4 PARTICIPATING MTG REITS	13	0	13	7855	12.39	1.24	1.24	12.75	-1.9	-1.8	10.3	9.7	2.9	10.0	1464.3
5 MAJOR HOMEBUILDERS	8	4	12	16509	10.03	0.25	1.42	18.43	-1.1	28.0	13.0	1.4	83.8	14.2	3128.1
6 OTHER BLDRS/DEVELOPERS	9	26	35	5772	5.50	0.10	0.08	8.65	-5.8	3.9	103.7	1.1	57.2	1.5	1749.2
7 INCOME PROP BLDR/OWNR	15	11	26	5760	10.64	0.69	0.78	18.01	0.6	12.5	23.1	3.8	69.4	7.3	3148.7
8 MORTGAGE BANKER/FINANCE	11	4	15	10561	12.91	0.86	0.80	17.12	-7.4	6.6	21.4	5.0	32.5	6.2	4053.2
9 DIVERSIFIED RLTY&HOLDING	12	9	21	22722	13.02	0.27	0.99	17.90	-3.2	13.2	18.1	1.5	37.5	7.6	13510.2
10 RLTY SVCS/SYNDICATORS	3	3	6	8072	6.44	0.05	-0.07	7.75	-5.6	-25.6	0.0	0.6	20.3	-1.1	355.2
11 MANUFACTURED HOUSING	3	6	9	13159	5.71	0.15	0.29	8.19	-4.3	-12.7	28.5	1.8	43.5	5.0	1039.5
1 LIQUIDATING COMPANIES	1	0	1	5954	2.60	0.19	-0.60	4.88	5.4	-25.0	NC	NC	87.5	NC	29.0
P PREFERRED STOCKS	2	0	2	1923	11.25	0.93	0.00	14.38	-4.2	10.0	NC	NC	27.8	NC	56.2
OVERALL AVERAGE			226	8747	10.62	0.79	0.96	14.67	-1.2	8.5	15.2	5.4	38.2	7.5	36914.2
DOW JONES INDUSTRIALS							103.39	1879.50	-0.1	21.5	18.2	3.6			
STANDARD & POOR'S 500							14.52	247.06	-1.1	16.9	17.0	3.3			
DOW JONES UTILITIES							13.95	211.35	-3.6	20.9	15.2	7.1			